

Bank of North Dakota

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Bank of North Dakota

Major Rating Factors

Strengths:

- Ownership by North Dakota
- Good capitalization
- Strong asset quality

Counterparty Credit Rating

A+/Stable/A-1

Weaknesses:

- Concentration in North Dakota
- Large indirect exposure to agriculture
- A risk profile subject to shifting political conditions
- Limited capital flexibility

Rationale

Standard & Poor's Ratings Services' rating on Bank of North Dakota (BND) reflects its ownership by the state of North Dakota (A+/Stable/--). The rating is also based on the application of our criteria for government-related entities (GRES), as a result of which we impute a one-notch uplift from the company's 'A' stand-alone credit profile (SACP). In our opinion, there is a high likelihood that the state of North Dakota would provide timely and sufficient extraordinary support to BND, as the state owns, controls, and maintains BND. Moreover, the state explicitly guarantees all deposits in BND, as codified in the North Dakota Century Code (NDCC §6-09-10). The deposit rating of 'AA+' parallels that of the state of North Dakota. No other liabilities have an explicit guarantee.

Our SACP on BND reflects the bank's good capital and strong asset quality. The bank's concentration in the state of North Dakota, indirect exposure to agriculture, limited capital flexibility, and risks related to the changing political environment, constrain the ratings.

Capital is a strong point for BND, and the bank ranks high among its rated peer group. However, capital is usually limited by the large appropriation the bank typically makes to the state's general fund. Positively, BND will not have to make any appropriation payout for 2010 or 2011, due to the strength of the state's financial performance. This should further enhance the company's capital as the bank will be able to retain its earnings.

Despite its concentration in one state, BND has a relatively diverse loan portfolio and maintains strong asset quality, which is also better than those of its comparably rated peers. BND serves as correspondent to many of the state's banks. Therefore, the health of these institutions could directly affect that of BND. North Dakota banks are mainly smaller community institutions that have not been immune to the economic recession. Despite asset-quality pressures on some banks in North Dakota, the relative strength of North Dakota's economy and the guarantees on BND's loan portfolio should keep BND's asset-quality ratios above average, we believe. BND's historic and current strong asset-quality measures, with no charge-offs at March 31, 2010, further mitigate the matter.

North Dakota's steadily growing economy throughout economic cycles buttresses the rating on BND. Further, the state of North Dakota boasts the lowest unemployment rate in the U.S. at 4%, as of the end of March. Due to the extensive reach of agriculture in the state's economy, all loans, regardless of type, are affected by agriculture.

Therefore, BND's lending portfolio is indirectly related to the agricultural sector. Nonetheless, the economy of North Dakota continues to post strong revenue performance when many other states continue to struggle. This strong performance is attributed to its two key sectors--oil production and agriculture--mitigating our agricultural concern at the moment.

Any significant changes in the political environment of the state that result in legislative change could materially affect the bank's risk profile. We consider this risk to be low, as ongoing changes in the political landscape have not led to any material changes in the bank's financial condition since its inception in 1919.

We are nonetheless concerned that a large percentage of BND's deposits come from the state of North Dakota. However, this concentration risk is mitigated because state law requires all state funds and funds of state institutions, with few exceptions, to be deposited with BND.

Outlook

The stable outlook reflects our expectations that BND should continue to perform well throughout this economic environment and that asset quality will remain acceptable. We could lower the ratings if the state's economy deteriorates, or if asset-quality levels deteriorate significantly, pressuring BND's earnings. A change in the political atmosphere could affect the ratings either positively or negatively.

Profile: Unique Business Model In Its State

We view BND's business model as unique. Headquartered in Bismarck, N.D., the bank was created due to a dearth of lenders in the state willing to support local businessmen and farmers. The bank's static membership supports its primary role in financing economic development in North Dakota.

Despite its narrow focus, BND is the second-largest bank in the state, measured by deposits. The bank's deposits are not federally insured and it gets no oversight from U.S. government authorities or banking regulatory bodies. Still, the state is required by law to guarantee all of BND's deposits. Because of this guarantee, we rate the deposits 'AA+', the same level as the state. No other liabilities have an explicit guarantee. The bank has only one office and acts as the agent of several state-legislated programs, as a lender, as a depository for state agency funds, and as a correspondent bank to private financial institutions in the state.

Government Support and GRE Methodology Impact

The state of North Dakota owns, controls, and maintains BND. The bank has a seven-member advisory board appointed by the governor. This board reviews BND's operations and makes recommendations to the State Industrial Commission relating to BND's management, services, policies, and procedures. Members of the Industrial Commission are the Governor, who acts as chairman; the Attorney General; and Agriculture Commissioner of the state of North Dakota. Moreover, the state explicitly guarantees all deposits in BND as codified in the North Dakota Century Code (NDCC §6-09-10).

In accordance with our GRE criteria, we base our view of a high likelihood of extraordinary government support on our assessment of BND:

- Its important role in promoting the state government's economic development and stabilization process by delivering quality, sound financial services that promote agriculture, commerce, and industry in North Dakota.
- Its integral link with the state government, as the bank acts as the agent of several state-legislated programs, as a lender, as a depository for state agency funds, and as a correspondent bank to private financial institutions in the state.

Strategy: Supporting State Financial Needs

We regard BND's management strategy as conservative and supportive of the bank's business goals. Management has worked with state agencies and private banks in the state to promote charter objectives. We expect management to continue meeting the needs of its customers as it fulfills its mission to deliver quality, sound financial services that promote agriculture, commerce, and industry in the state. As we expected, loan growth was moderate in 2009, at 3.6% relative to the 30% growth the bank experienced during 2008. The changes in the student loan industry, with the elimination of the Federal Family Education Loan Program, will have a significant effect on BND. Consequently, as of July 1, 2010, BND no longer provides loans through this program, which had generated \$120 million-\$130 million in volume per year for the bank. The bank will continue to issue loans from the Dakota Education Alternative Loan program. We expect loan growth to remain steady in 2010 relative to 2009.

Risk Profile And Management: Adequate

We assess BND's enterprise risk management as adequate. The bank has instituted corporate-wide risk systems that establish risk limits, risk identification, and risk monitoring. Senior management has identified policy objectives consistent with the legislative goals established for BND, which are within the bank's managed-risk limitations. BND has formulated good asset-liability management, an assured source of deposit funding, and strong asset-quality measures.

The bank's main risk is credit risk, but interest rate risk is also important. Positively, the U.S. government's guarantee of the majority of BND's loan portfolio mitigates credit risk. The fact that a large percentage of BND's deposits come from the state represents a weakness, but this concentration risk is mitigated because state law requires these deposits, with few exceptions, to be made with BND. BND's primary revenue sources include direct student lending, residential loan purchases, commercial and agricultural loan participations, and treasury services, which include federal funds purchases and sales. The bank has a moderate risk related to political developments in the state, but we view this risk as low.

Credit risk: Minimal

BND's credit risk is minimal and, at the moment, not a major concern. The bank is restricted from initiating and originating commercial loans exclusively for its own account, but it participates in loans that other North Dakota-based commercial banks originate. Although other institutions have experienced some pain from the weakened national economic environment, we do not expect this to have a material effect on BND's performance. The bank has guarantees, reserves, and workout programs that help mitigate this concern. Federal and state agencies guaranteed 52% of the loan portfolio at March 31, 2010. BND uses these guaranty programs to reduce its exposure to risks to the agricultural economy.

BND's relatively diverse loan portfolio totaled \$2.8 billion at March 31, 2010, a 5% increase from a year ago.

Student loans totaled \$1.0 billion (36% of the loan portfolio, of which 97% is guaranteed). Commercial loans totaled \$1.02 billion (37% of the loan portfolio, 5% guaranteed). Residential loans totaled \$475.2 million (17% of the loan portfolio; 83% FHA or VA guaranteed). Agricultural loans totaled \$260 million (9% of the loan portfolio; 7% guaranteed). State institution loans totaled \$5.8 million (less than 1% of the total portfolio; 100% guaranteed).

Agriculture and energy are the two most important industries in the state. Even though agricultural lending is not as significant as other lending conducted by the bank, the agricultural economy affects the entire state economy to a large degree. As a result, many of BND's loan customers are indirectly related to the economy of agriculture. At this time we don't see this as a high risk because the state economy continues to perform well and boasts the lowest unemployment rate in the country.

The loan portfolio overall grew marginally year-over-year at 3.6%. A 20% increase in student loans buttressed slight declines in the bank's other loan categories. Given the changes in the student loan industry, with the elimination of the Federal Family Education Loan Program, we do not expect the same increase in student loans the bank experienced for 2009. We expect loan balances to remain steady during the next year.

Overall, BND's loan quality is strong and compares favorably with that of rated peers. Nonperforming loans plus those 90-plus days past due amounted to 1.58% at March 31, 2010, up 25 basis points from 1.33% last year. Net charge-offs in the portfolio have been managed exceptionally well for the past few years. In fact, BND had no loan losses at March 31, and a low 0.18% net charge-offs-to-average loans ratio at Dec. 31, 2009. Given these indicators, BND has good reserves, with a reserves-to-loans ratio of 1.65%. We expect credit quality to remain favorable at the bank given the guarantees included in its portfolio, the conservative nature of its business, and the financial health of North Dakota.

Funding and liquidity risk

BND's funding profile, similar to other aspects of its business, is different from that of other commercial banks. By state law, all state funds and funds of state institutions, with few exceptions, are deposited with BND. The bank also accepts "private" deposits, which may come from any source--from private citizens to the U.S. government. None of these deposits is federally insured, but they are guaranteed by the state.

Although legislation has created a captive deposit base, the duration of deposits is variable because they fluctuate with revenue and expense streams related to financing state government, and we therefore do not include them in our core deposit calculation. We believe management has dealt with this uncertainty appropriately by maintaining an adequate degree of liquidity and using other forms of funding.

BND's balance sheet at March 31, 2010, consisted of 32% liquid assets. Noncore deposits provided the majority of BND's funding, as core deposits constituted roughly 28% of the funding base at that date. Because core deposits do not fully fund the loan portfolio, the loan-to-core deposits ratio (253% of core deposits at March 31) is high compared with other banks'. Noncore deposits primarily consisted of large certificates of deposits from local state agencies, which the law requires them to deposit at BND. When adding these state-sourced captive deposits to the core deposits, the loan leverage ratio improves materially to 122%. Although these deposits are not considered core based on our definition, we recognize their stickiness and therefore do not view these measures as negative rating factors for BND. Furthermore, the state provides certain guarantees to BND that support the rating.

The duration of the captive deposit base is variable. Consequently, the bank may seek additional funding from Federal Home Loan Bank advances and borrow from the Federal Reserve discount window. Also, it can enter into a

repurchase agreement using the securities in its investment portfolio as collateral.

Some additional liquidity is available in the investment portfolio, which totaled \$408 million at March 31, 2010, representing 10% of total assets. The investment portfolio is classified as 100% available for sale. More than 90% of the portfolio is invested in 'AAA' rated securities. The portfolio's duration was 4.5 years.

Accounting

Even though there is no federal oversight, the state's department of financial institutions examines BND at least once each 24 months, and an independent auditor--Brady, Martz & Associates P.C.--audits the annual financials.

Profitability: Strong

BND's earnings are strong, generating \$15 million in the first quarter, similar to last year's earnings. The challenges that have plagued many other financial institutions have had minimal effect on BND. The bank is tax exempt and pays no deposit insurance premiums, and does not require the deposit-taking overhead of a large branch network. In addition, the bank enjoys a captive deposit base not dependent, as most commercial banks are, on expensive "brick-and-mortar" branches and related overhead costs. The average efficiency ratio for commercial banks in North Dakota was in the mid-50% area, while the overhead ratio for BND was 21.22%, as of March 31, 2010.

The net interest margin has been relatively low, generating less than 3% each year. Due to the nature of BND's business and its static customer base, we expect any variability in the net interest margin to be generated primarily by interest rate changes. Nevertheless, profits continue to improve year-over-year.

The state of North Dakota continues to perform well financially. Consequently, the bank does not have to make its usual relatively large annual appropriation payout to North Dakota's general fund in 2010 or 2011. This appropriation typically places the bank among the top-five revenue generators for the general fund. The appropriation payout was \$30 million in each of 2008 and 2009. This usually reduces the bank's profitability and limits capital flexibility. Because of the low-risk nature of the bank's balance sheet, we expect this hiatus from payment to boost its profitability and, accordingly, its capital levels, at least for the next two years.

Table 1

Bank of North Dakota Profitability Ratios				
	--Year-ended Dec. 31--			
(%)	2009	2008	2007	2006
Net interest income/average earning assets	2.7	2.8	2.8	2.8
Net interest income/revenues	92.9	91.8	90.7	87.7
Fee income/revenues	3.2	3.8	5.0	0.0
Market-sensitive income/revenues	0.1	0.1	(0.1)	(0.8)
Personnel expense/revenues	12.0	11.5	12.5	13.7
Noninterest expenses/revenues	21.8	22.1	24.7	26.7
New loan loss provisions/revenues	11.8	10.6	4.3	5.4
Net operating income before loan loss provisions/loan loss provisions	663.9	732.3	1,747.9	1,360.4
Net operating income after loan loss provisions/revenues	66.4	67.3	71.0	68.0
Pretax profit/revenues	66.4	68.0	71.0	68.0

Table 1

Bank of North Dakota Profitability Ratios (cont.)				
Tax/pretax profit	0.0	0.0	0.0	0.0
Core earnings/revenues	66.4	67.3	71.0	68.0
Core earnings/average adjusted assets	1.6	1.8	2.0	2.0
Noninterest expenses/average adjusted assets	0.5	0.6	0.7	0.8
Core earnings/average risk-weighted assets	2.8	3.0	3.5	3.4
Core earnings/average adjusted common equity	23.4	27.0	28.9	26.1
Pretax profit/average common equity (%)	23.4	27.3	28.7	26.3

Capital: Strong

Capital on a risk-adjusted basis is strong and ranks high among rated peers, reflecting the moderate-risk asset mix and good earnings performance, despite BND's limited capital flexibility. We expect that, amid North Dakota's two-year suspension of BND's usually large annual appropriation payout to the state general fund, the bank's retention of these funds may help to improve not only its profitability but also its already strong capital.

We view the quality of the bank's capital as excellent, which consists of retained earnings and common equity. BND's regulatory capital ratios are good, with 7.09% leverage, 15.21% Tier 1, and 16.48% total risk-based capital ratios reported at March 31, 2010. Its adjusted total equity-to-risk assets and adjusted common equity-to-risk assets ratios at that date were 17.59% and 15.21%, respectively.

Table 2

Bank of North Dakota Capital Ratios				
	--Year-ended Dec. 31--			
(%)	2009	2008	2007	2006
Adjusted common equity/risk assets (%)	12.9	10.7	11.9	12.2
Tier 1 capital ratio	12.9	10.7	11.9	12.2
Adjusted total equity/adjusted assets	7.9	7.5	8.0	8.3
Adjusted total equity/managed assets	7.9	7.5	8.0	8.3
Adjusted total equity plus loan loss reserves (specific)/customer loans (gross)	11.5	10.1	11.1	11.1
Common dividend payout ratio	25.8	35.1	49.2	100.0

Table 3

Bank of North Dakota Summary Balance Sheet				
	--Year-ended Dec. 31--			
(Mil. \$)	2009	2008	2007	2006
Assets				
Cash and money market instruments	841.2	652.7	522.7	342.1
Securities	371.4	210.8	219.0	219.4
Trading securities (marked to market)	0.0	0.0	0.0	0.0
Nontrading securities	371.4	210.8	219.0	219.4
Mortgage-backed securities included above	182.7	128.0	113.7	99.6
Loans to banks (net)	0.0	0.0	0.0	0.0
Customer loans (gross)	2,713.6	2,618.4	2,005.0	1,755.6

Table 3

Bank of North Dakota Summary Balance Sheet (cont.)				
Loan loss reserves	42.5	36.8	32.9	30.1
Customer loans (net)	2,671.1	2,581.7	1,972.1	1,725.4
Earning assets	3,109.2	2,904.8	2,501.6	2,104.1
Equity interests/participations (nonfinancial)	26.0	20.7	16.5	N/A
Investments in unconsolidated subsidiaries (financial companies)	N/A	N/A	0.0	N/A
Intangibles (nonservicing)	0.0	0.0	0.0	0.0
Interest-only strips	0.0	0.0	0.0	N/A
Fixed assets	12.1	12.8	11.6	7.1
Derivatives credit amount	0.0	0.0	0.0	N/A
Accrued receivables	34.5	35.3	34.2	30.2
All other assets	3.3	3.2	3.2	2.4
Total assets	3,959.7	3,517.0	2,779.4	2,326.7
Intangibles (nonservicing)	0.0	0.0	0.0	0.0
Minus insurance statutory funds	0.0	0.0	0.0	0.0
Adjusted assets	3,959.7	3,517.0	2,779.4	2,326.7
Liabilities				
Total deposits	3,268.6	2,946.3	2,205.2	1,617.1
Noncore deposits	2,041.3	2,056.0	1,449.8	0.0
Core/customer deposits	1,227.2	890.3	755.4	1,617.1
Acceptances	0.0	0.0	0.0	0.0
Repurchase agreements	8.1	3.1	100.6	249.1
Other borrowings	405.0	315.6	245.1	257.2
Other other borrowings	0.0	0.0	0.0	257.2
Other credit reserves	N/A	N/A	N/A	N/A
Other liabilities	6.3	28.1	36.0	39.7
Total liabilities	3,688.0	3,293.0	2,586.9	2,163.2
Total equity	271.6	223.9	192.5	163.5
Mandatorily convertible securities	0.0	0.0	0.0	0.0
Limited life preferred and quasi equity	0.0	0.0	0.0	0.0
Enhanced trust preferred	0.0	0.0	0.0	0.0
Minority interest-equity	N/A	N/A	0.0	N/A
Common shareholders' equity (reported)	271.6	223.9	192.5	163.5
Share capital and surplus	44.0	44.0	44.0	44.0
Revaluation reserve	1.7	(3.0)	2.6	(0.4)
Retained profits	226.0	182.9	145.8	119.9
Other equity	N/A	N/A	0.0	N/A
Total liabilities and equity	3,959.7	3,517.0	2,779.4	2,326.7

N/A--Not applicable.

Table 4

Bank of North Dakota Equity Reconciliation Table				
	--Year-ended Dec. 31--			
(Mil. \$)	2009	2008	2007	2006
Common shareholders' equity (reported)	271.6	223.9	192.5	163.5
Plus minority interest (equity)	0.0	0.0	0.0	0.0
Minus dividends (not yet distributed)	0.0	0.0	0.0	0.0
Minus revaluation reserves	(1.7)	3.0	(2.6)	0.4
Minus nonservicing intangibles	0.0	0.0	0.0	0.0
Minus interest-only strips (net)	0.0	0.0	0.0	0.0
Minus tax loss carryforwards	0.0	0.0	0.0	0.0
Minus postretirement benefit adjustment	0.0	0.0	0.0	0.0
Minus other adjustments	N/A	0.0	0.0	0.0
Adjusted common equity	270.0	226.9	189.8	163.9
Plus admissible preferred and hybrids	0.0	0.0	0.0	0.0
Plus general reserves	41.0	35.6	31.9	29.4
Plus unrealized gains	N/A	0.0	0.0	0.0
Minus equity in unconsolidated subsidiaries	0.0	0.0	0.0	0.0
Minus capital of insurance subsidiaries	N/A	0.0	0.0	0.0
Minus adjustment for securitized assets	0.0	0.0	0.0	0.0
Adjusted total equity	311.0	262.5	221.8	193.3

N/A--Not applicable.

Table 5

Bank of North Dakota Profit And Loss				
	--Year-ended Dec. 31--			
(Mil. \$)	2009	2008	2007	2006
Net interest income	81.3	76.8	65.3	55.3
Interest income	132.3	148.6	152.4	126.6
Interest expense	51.0	71.8	87.1	71.3
Operating noninterest income	6.2	6.8	6.7	7.7
Fees and commissions	2.8	3.2	3.6	0.0
Net brokerage commissions	0.0	0.0	0.0	0.0
Trading gains	0.0	0.0	0.0	0.0
Other market-sensitive income	0.1	0.1	(0.1)	N/A
Net insurance income	0.0	0.0	0.0	0.0
Equity in earnings of unconsolidated subsidiaries	0.0	0.0	0.0	0.0
Other noninterest income	3.4	3.5	3.1	8.3
Operating revenues	87.5	83.7	72.0	63.1
Noninterest expenses	19.1	18.5	17.8	16.8
Personnel expenses	10.5	9.6	9.0	8.6
Other general and administrative expense	8.6	8.9	8.8	7.2
Net operating income before loss provisions	68.4	65.2	54.2	46.3
Credit loss provisions (net new)	10.3	8.9	3.1	3.4
Net operating income after loss provisions	58.1	56.3	51.1	42.9

Table 5

Bank of North Dakota Profit And Loss (cont.)				
Nonrecurring/special income	0.0	0.6	0.0	0.0
Nonrecurring/special expense	0.0	0.0	0.0	0.0
Amortization of intangibles	0.0	0.0	0.0	0.0
Impairment of intangibles	0.0	0.0	0.0	0.0
Pretax profit	58.1	56.9	51.1	42.9
Tax expense/credit	0.0	0.0	0.0	0.0
Net income (before minority interest)	58.1	56.9	51.1	42.9
Minority interest in consolidated subsidiaries	0.0	0.0	0.0	N/A
Net income before extraordinary	58.1	57.0	51.1	42.9
Net income after extraordinary	58.1	57.0	51.1	42.9

N/A--Not applicable.

Table 6

Bank of North Dakota Core Earnings Reconciliation Table				
	--Year-ended Dec. 31--			
(Mil. \$)	2009	2008	2007	2006
Net income (before minority interest)	58.1	56.9	51.1	42.9
Minus nonrecurring/special income	(0.0)	(0.6)	0.0	0.0
Plus nonrecurring/special expense	0.0	0.0	0.0	0.0
Plus or minus tax impact of adjustments	0.0	0.0	0.0	0.0
Plus amortization/impairment of goodwill/intangibles	0.0	0.0	0.0	0.0
Minus preferred dividends	0.0	0.0	0.0	0.0
Plus or minus other earnings adjustments	0.0	0.0	0.0	0.0
Core earnings	58.1	56.3	51.1	42.9

Related Criteria And Research

- Enhanced Methodology And Assumptions for Rating Government-Related Entities, June 28, 2009
- Bank Rating Analysis Methodology Profile, March 18, 2004

Ratings Detail (As Of July 27, 2010)*

Bank of North Dakota

Counterparty Credit Rating	A+/Stable/A-1
Certificate Of Deposit	
Local Currency	AA+/A-1+

Counterparty Credit Ratings History

30-Jul-2009	A+/Stable/A-1
08-Jun-2009	A/Stable/A-1
22-Dec-2008	AA/Watch Neg/A-1+
16-Sep-2005	AA/Stable/A-1+

Sovereign Rating

United States of America	AAA/Stable/A-1+
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*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard

Ratings Detail (As Of July 27, 2010)***(cont.)**

& Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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